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FEDERAL COMMUNICATIONS COMMISSION
OFFICE OF THE SECRETARY

Before the
FEDERAL COMMUNICATIONS COMMISSION
Washington, D.C. 20554

In the Matter of	)	
	)	
Amendment of Parts 32 and 64 of the Commission's Rules to Account for Transactions between Carriers and Their Nonregulated Affiliates	)	CC Docket No. 93-251

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COMMENTS OF BELLSOUTH

BELLSOUTH TELECOMMUNICATIONS, INC.

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SUMMARY

The Commission adopted the present affiliate transaction rules in direct response to perceived incentives under cost of service regulation to cross-subsidize nonregulated activities from regulated operations. Subsequently, the Commission adopted incentive regulation. The Commission found that incentive regulation eliminated the incentives to cross-subsidize that were the justification for the affiliate transaction rules.

In the Notice, the Commission concedes that incentive regulation provides carriers with efficiency incentives far stronger than those that the existing affiliate transaction rules sought to preserve. Logically, one would expect that the Notice would propose to ease or eliminate the existing rules. Instead, the Notice proposes to adopt rules that are far more onerous than the existing rules. The failure of the Notice to align the proposed rules with the facts found violates the test for rational decision making. Therefore, the Commission must reject the proposed rules.

In these comments, BellSouth demonstrates that the proposed rules would impose an extreme administrative burden on the carriers and the Commission. The two aspects of the proposed rules that would be most burdensome are the curtailment of the use of prevailing company price as a valuation method, and the application of the asset transfer rules to services. The rationale for using prevailing

company price as a valuation method is that the existence of a substantial number of nonaffiliate transactions provides a reasonable assurance that the price charged reflects market value. Nothing in the Notice undermines this rationale.

The application of the asset transfer rules to services would require that carriers and their affiliates determine both the fully distributed cost and the fair market value of the services that are subject to affiliate transactions. While there are recognized methods to determine the fair market value of physical assets, there are no comparable methodologies for the evaluation of services. The adoption of the proposed rule for service transactions would lead to excessive administrative costs and uncertainties.

In order to evaluate the burden that would be imposed by the adoption of the proposed services rule, BellSouth has retained the firm of Theodore, Barry & Associates ("TB&A"). In the short time available since the release of the Notice, TB&A has conducted a preliminary analysis of the impact of the proposed services rule on BellSouth. Its preliminary conclusions include the following:

--The only theoretically sound method of determining "fair market value" for services involves an alternative provider analysis.

--There are certain limitations on the ability of an analyst to conduct an alternative provider analysis that must be overcome. These limitations are most easily overcome for transaction based services, i.e., services involving routine, repetitive, production-oriented activities where it is possible to clearly define the work product. Examples of transaction based services include shareowner services and accounts payable. The limitations are much more constraining for knowledge based services, i.e., services involving non-routine, non-repetitive, advisory and oversight oriented activities where it is difficult to clearly define the work product. Examples of knowledge based services include corporate planning and tax planning.

--While it is possible to estimate fair market value for transaction based services with some degree of confidence, such estimates would be extremely unreliable and of questionable usefulness for knowledge based services.

--A large proportion of BellSouth's existing affiliate transactions involve knowledge based services that do not readily lend themselves to meaningful alternative provider analysis, and hence to estimates of fair market value.

--A major difficulty with the proposal to use "fair market value" to evaluate service transactions is to ensure consistency in approach and interpretation.

--The cost of conducting alternative provider analyses would be considerable.

In BellSouth's view, adoption of the proposals in the Notice would be extremely costly to both the carriers and the Commission. There would be little, if any, benefit to ratepayers. Therefore, the Commission should reject the proposals contained in the Notice. Instead, the Commission should consider eliminating the existing asset transfer rules altogether. Alternatively, the Commission should consider ways to simplify and reduce the burden of the existing rules.

One possibility would be to eliminate the current asymmetrical asset transfer rules, and replace them with a net book cost requirement. The Commission has previously used net book cost as a surrogate for market value. For those categories of assets where there is some likelihood that market value may exceed net book cost, such as land and buildings, the Commission could retain the present rule. This approach would protect ratepayer interests while reducing the administrative burden of the existing rules.

In these Comments, BellSouth discusses the detailed proposals for the determination of fully distributed cost contained in the Notice. These proposals represent a classic case of unnecessary and inefficient regulation that will impose substantial costs and no benefits to the public. They should be rejected by the Commission.

BellSouth urges the Commission to consider the cost and benefit of any changes in the affiliate transaction rules. Affiliate transaction rules impose severe administrative burdens on carriers and their affiliates that lead to no increase in output. As such, these rules reduce the productivity and efficiency of persons subject to their requirements. This, in turn, affords an unearned competitive advantage to those persons not subject to such burdens. The Commission should impose such requirements only when clearly necessary to protect ratepayers from a substantial risk of harm. The Notice utterly fails to justify the proposed affiliate transaction rules under this standard.

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BellSouth Telecommunications, Inc. ("BellSouth") hereby offers comment in the captioned proceeding in response to the Notice of Proposed Rulemaking ("Notice"), FCC 93-453, released October 20, 1993.

I. Introduction

The current affiliate transaction rules were adopted in the Joint Cost Order released in 1987.[1] At that time, rate of return regulation was the regulatory regime applied to all carriers actively regulated by the Commission. The Commission found that concerns about cross-subsidy warranted the adoption of affiliate transaction rules.[2] The Commission explicitly tied the need for affiliate transaction rules to the existence of cost-of-service regulation. Citing the comments of the Department of

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[1] Separation of Costs of Regulated Telephone Service from Costs of Nonregulated Activities, Report and Order, CC Docket No. 86-111, 2 FCC Rcd 1298 (1987) ("Joint Cost Order"), recon., 2 FCC Rcd 6283 (1987), further recon., 3 FCC Rcd 6701 (1988), aff'd. sub nom., Southwestern Bell Corp v. FCC, 896 F.2d 1378 (D.C. Cir. 1990).

[2] Joint Cost Order, 2 FCC Rcd at 1334, ¶ 284. The tie between the affiliate transaction rules and cost-of-service regulation is acknowledged in the Notice at ¶¶ 8-10.

Justice, the Commission noted that affiliate transaction rules were justified by the possibility of cost shifting to regulated ratepayers.

> 290. Our goal in establishing standards for transactions between affiliates is to prevent cost shifting to ratepayers by means of improper transfer pricing. The Department of Justice, in its Comments (at pp. 38-39) states the concern succinctly:
>
> > If a firm produces nonregulated inputs needed to produce its regulated products, it has an incentive to cross-subsidize by selling itself those inputs at prices higher than the cost of producing them. This would increase the "cost" of the regulated product, but it would also increase the firm's total revenues because, under cost-based regulation, the regulators would permit a corresponding increase in the price of the regulated product. The carrier, therefore, would retain on the nonregulated side the higher profit resulting from the above-cost price paid by the regulated firm to its affiliate. Conversely, if assets or services of a regulated business are sold to a nonregulated affiliate at too low a price, profits on the nonregulated side will increase. The loss to the regulated business will increase the service's revenue requirement and be recovered from ratepayers. (footnote omitted)[3]

By 1989, the Commission had recognized that cost-of-service regulation imposed an extremely high cost on society.[4] In the AT&T Price Cap Order, the Commission held

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[3] Joint Cost Order, 2 FCC Rcd at 1335, ¶ 290.

[4] In the Matter of Policy and Rules Concerning Rates for Dominant Carriers, CC Docket No. 87-313, Report and Order and Second Further Notice of Proposed Rulemaking, FCC No. 89-91, released April 17, 1989 ("AT&T Price Cap Order"),

that replacing cost-of-service regulation with price regulation eliminated carrier incentives to cross-subsidize.

> [I]ncentive regulation eliminates the incentive to shift costs to regulated services from nonregulated services. Under incentive regulation, all that a carrier accomplishes by moving costs to regulated services is to depress earnings, not to increase them. Incentive regulation, coupled with our existing regulatory controls to deter cross-subsidy, should substantially discourage anticompetitive activities involving cost shifting between regulated and nonregulated lines of business." (Citing the Joint Cost Order.)[5]

Thus, as the Commission has long recognized, price regulation eliminates incentives for regulated carriers to cross-subsidize nonregulated operations, and provides carriers with an unambiguous incentive to reduce costs and increase revenues, regardless of whether those costs and revenues are incurred in transactions with affiliates.

The Commission implemented price regulation for AT&T in 1989 and for the local exchange carriers ("LECs") in 1991. In light of this change in the regulatory structure applicable to these carriers, one might expect the present

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at ¶ 34.

[5] AT&T Price Cap Order at ¶ 104. At ¶ 36, the Commission found: "In the face of such [price] constraints, a carrier's primary means of increasing earnings are to enhance its efficiency and innovate in the provision of service. Because cost padding and cross-subsidization do not justify higher prices under this system — but instead lower profits — the incentives to engage in such activity are limited. The system is also less complex than rate of return regulation and easier to administer in the long run, which should reduce the cost of regulation." See also AT&T Price Cap Order at ¶ 84.

Notice to propose the elimination of obsolete affiliate transaction rules for price cap carriers, in order to capture promised administrative savings for carriers and the public.[6]

To the contrary, the Notice proposes to adopt affiliate transaction rules that are far more onerous than those applied under rate of return regulation. Indeed, the Notice contains proposals that were expressly rejected in the Joint Cost Order as contrary to the public interest, even for carriers subject to cost-of-service regulation.[7] The justification offered in the Notice for the proposed change in policy is irrational, and must be rejected.

In BellSouth's view, the Notice is fatally flawed. It does not establish any need for the proposed rule revisions. More alarming, the Notice is completely devoid of any analysis of cost versus benefit relating to the proposed rule changes. As shown below, the proposed rules are not needed to protect ratepayers from carrier inefficiency or imprudence. Implementation of the proposed rules would be so onerous as to make beneficial affiliate transactions economically prohibitive, thereby depriving both carriers and ratepayers of significant efficiencies and economies. In addition, both the Commission and the carriers would

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[6] See, e.g., AT&T Price Cap Order at ¶¶ 36, 107, and 113.

[7] Compare Notice, ¶ 24 with Joint Cost Order, 2 FCC Rcd at 1336, ¶ 294.

incur substantially increased administrative costs without any concurrent public benefit. Therefore, BellSouth urges the Commission to reject the proposed rules. Instead, the Commission should use this proceeding to eliminate or simplify its affiliate transaction rules and tailor those rules to a price regulation regime for price cap carriers.

II. The Proposed Rules Are Unnecessary

The Notice alleges that changes in the affiliate transaction rules are necessary because of changes in the Commission's regulatory approach since the adoption of the Joint Cost Order. The Commission notes that it has adopted price cap regulation for AT&T and the large LECs, and optional incentive regulation for other LECs subject to the affiliate transaction rules.[8] The Notice recognizes that these changes give the effected carriers "efficiency incentives far stronger than those the valuation methods for affiliate services sought to preserve."[9] Logically, such findings should serve as a predicate for easing or eliminating the existing affiliate transaction rules. The Notice instead irrationally proposes to use these facts to justify much more onerous rules.

The Commission's accounting rules embrace generally accepted accounting principles ("GAAP").[10] They require

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[8] Notice at ¶ 31.

[9] Id.

[10] 47 C.F.R. § 32.1.

carriers to record as their revenues and costs "the actual amount they pay to and are entitled to receive from their suppliers and customers."[11] This is because such arms-length transactions are presumed to reflect market value. Affiliate transactions were singled out for more stringent scrutiny because the potential for "cost padding" and "cross-subsidization" inherent in cost-of-service (rate of return) regulation could result in higher prices to customers of the regulated carrier. As noted in the Introduction, above, the adoption of price regulation eliminated those concerns. Under price regulation, carriers dealing with affiliates on other than a market value basis forego earnings with no corresponding benefit. Therefore, the adoption of incentive regulation renders unnecessary the affiliated transaction exception to GAAP.

The Notice, however, posits a situation in which a carrier subject to incentive regulation provides services to an affiliate below market value, or purchases services from its affiliate at more than market value.[12] According to the Notice, this irrational conduct could occur because the Commission's rules require that such transactions be recorded on the carrier's books at fully distributed cost.

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[11] Notice at ¶ 2.

[12] The Notice does not explain why a carrier would engage in such transactions since under incentive regulation such transactions would lower carrier profitability. The Notice gives not one concrete example of such conduct by a carrier subject to incentive regulation.

Implicit in the hypothetical posited in the Notice is an assumption that there is likely to be a significant difference between cost and market value. This assumption is contrary to prior Commission findings that cost provides a reasonable surrogate for market value, especially in situations where it is impractical to estimate market value directly. Thus, when the Commission was faced with estimating the market value of embedded customer premises equipment assigned to AT&T at divestiture, the Commission ultimately concluded that it was impractical to appraise the market value of the myriad assets involved and found that net book cost provided a reasonable surrogate for market value.[13] The use of cost as a surrogate for market value is also consistent with the generally accepted economic theory that in a competitive marketplace prices will be driven to cost. The Commission adopted the fully distributed cost standard as a surrogate for market value, and nothing in the Notice demonstrates that such a surrogate has disadvantaged ratepayers. The Notice therefore fails to demonstrate that a change in the rules is necessary.

Even if the Commission determines that a change in the rules is necessary, the Notice fails to explain why this perceived problem could not be resolved by simply eliminating the requirement that services be booked at fully

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[13]See In the Matter of Procedures for Implementing the Detariffing of Customer Premises Equipment and Enhanced Services (Second Computer Inquiry), 6 FCC Rcd 6606 (1991).

distributed cost. In a price regulation environment, both parties to an affiliate transaction have an incentive to engage in the transaction only when the price charged equals market value. Thus, the need for a requirement to use "fully distributed cost" as a surrogate for market value is no longer apparent. As the Notice correctly states, the adoption of price caps, with their inherent efficiency incentives, "provide a basis for abandoning [the existing] methodology."[14] That conclusion, however, does not justify the imposition of even more onerous affiliate transaction rules. Instead, the analysis in the Notice supports the logical conclusion that affiliate transaction rules are not needed for carriers subject to incentive regulation. The Commission should consider this less costly and more efficient solution.

The Notice recognizes that a comprehensive review of the LEC price cap plan is scheduled to begin shortly.[15] The existence of the sharing mechanism in the LEC price cap plan is cited in the Notice as a possible reason for adopting different affiliate transaction rules for AT&T and the price cap LECs. The Commission will reevaluate the need for the sharing mechanism during that review.[16] BellSouth therefore recommends that the Commission defer consideration of the

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[14] Notice at ¶ 32.

[15] Notice at ¶ 103.

[16] Id.

rule changes proposed in this proceeding until after the conclusion of the comprehensive review of the LEC price cap plan.

As BellSouth has demonstrated above, there is no need to adopt the stringent affiliate transaction rules proposed in the Notice. Indeed, the changes in regulation that have occurred since the adoption of the Joint Cost Order have rendered even the existing affiliate transaction rules unnecessary. In addition, as shown below, the proposed rules would be prohibitively expensive to implement, if they could be implemented at all. In addition, the proposed rules are anticompetitive and could deprive LEC customers of economies and efficiencies that they presently enjoy.

III. The Costs Of Implementing The Proposed Rules Far Outweigh Any Possible Benefit That Would Result From Their Adoption

When the Commission imposed mandatory price cap regulation on AT&T and the largest LECs, it was recognized that price cap carriers would have to reduce costs and increase efficiency to be successful. Because price cap regulation aligns carrier incentives with those prevailing in fully competitive markets, the Commission anticipated that it would be able to streamline its regulatory processes for price cap carriers, thereby permitting reduced administrative costs.[17] These reduced regulatory costs were a substantial source of the expected productivity increase

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[17] AT&T Price Cap Order at ¶ 36.

that the price cap plan required carriers to achieve. The rules changes proposed in the Notice would require carriers to incur massive new administrative costs that would not result in any increase in output. As such, the proposed rules are inconsistent with the Commission's overall regulatory goals and the public interest.

Most of the increase in administrative costs comes from two of the proposals in the Notice: the proposal to severely curtail the use of prevailing company price as a valuation method; and the proposal to apply the present asset transfer rules to the provision of services.[18] The former proposal will increase administrative costs by requiring that transactions that today are valued under the prevailing company price be valued in the future using the more cumbersome default standard. This application of the present asset transfer rules to services will require that the carrier determine not only the fully distributed cost of such services, but also their estimated fair market value. In the context of asset transfers, this requirement is manageable, although burdensome, because asset transfers between regulated and nonregulated operations occur infrequently. Furthermore, physical assets can be valued using fairly straightforward and generally understood

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[18] A third major source of increased administrative costs comes from the proposal to prescribe detailed new methods of calculating fully distributed cost. These proposals will be discussed in the following section of these comments dealing with implementation issues.

methodologies. By contrast, services are provided between regulated and nonregulated operations on a far more frequent basis, and there are no comparable, widely available methodologies for determining the fair market value of services. Thus, extension of the present asset transfer rules to services will greatly increase costs and uncertainty to the regulated carriers.

A. The Proposed Rules Will Impose A Significant Administrative Burden on Carriers and the Commission.

BellSouth has three main areas of service related affiliate transactions that today are governed by the default fully distributed cost methodology: 1) BellSouth Telecommunications, Inc. ("BST") and BellSouth Corporation ("BSC"); 2) BST and Bell Communications Research, Inc. ("Bellcore"); and 3) BST and BellSouth Business Systems, Inc. ("BBS"). The types of services BST provides to and receives from each of these affiliates is listed in Section V of BellSouth's Cost Allocation Manual.

In an effort to assess the overall feasibility, and the administrative cost, of deriving estimated fair market value of affiliate transactions involving services between these affiliates, BellSouth has retained Theodore Barry & Associates ("TB&A") to review BellSouth's existing provision of services between BST and its affiliates.

TB&A is a general management consulting firm specializing in the telecommunications and energy industries. TB&A has long assisted both regulatory commissions and companies in assessing management and operational practices, such as planning and organization, and in various regulatory matters, such as affiliate relations and alternative regulatory frameworks.

TB&A currently is examining each of the major sources of affiliate transactions identified above to determine: 1) is there a feasible way to estimate the fair market value of the services provided between these entities; 2) are there straightforward, widely accepted methodologies available to perform such analyses, and 3) what is the estimated cost of conducting such analyses for BellSouth's existing affiliate transactions?

Due to the limited time available to parties to file comments in this proceeding, TB&A has been able to reach only preliminary conclusions on these issues. TB&A's initial view on each of these three issues is set forth below. BellSouth expects to be able to supply the Commission with a more complete analysis by TB&A in reply comments.

TB&A generally concludes that although determination of fair market value for assets follows generally accepted methodologies, applying a fair market value test to services is less feasible and risks inconsistency. The estimation of the fair market value of services is made complex by the relatively less defined nature of the service product and the related lack of a clear market proxy.

1. <u>While it is possible to estimate fair market value for transaction-based services with some degree of confidence, such estimates would be extremely unreliable, and of questionable usefulness, for knowledge-based services.</u>

The degree to which it is feasible to estimate the fair market value of services is largely dependent on the nature of the service. Two general categories of services may be defined for purpose of this analysis:

--Transaction based services, or those services involving routine, repetitive, production-oriented activities where it is possible to clearly define the work product. Examples include shareowner services and accounts payable.

--Knowledge-based services, or those services involving non-routine, non-repetitive, advisory and oversight oriented activities where it is difficult to clearly define the work product. Examples include corporate planning and tax planning.

In TB&A's view, an estimated fair market value of services can be determined only by comparison with alternative providers. In the case of transaction-based services, the availability of alternative providers is relatively high, as is the general usefulness and objectivity of alternative provider comparisons. In the case of knowledge based services, the availability of alternative providers is relatively low, as is the usefulness and general objectivity of alternative provider comparisons.

In conducting alternative provider analyses, TB&A has identified numerous potential limitations, which apply to all service to some extent, that must be considered:

--Ability to define the full scope of services.

--Ability to identify the actual cost of services.

--Ability to specify service levels.

--Ability to identify feasible alternative providers.

--Ability to obtain realistic and representative prices from alternative providers.

--Ability to, and cost of, effectively integrating alternative provider services into corporate processes.

Generally, these limitations are more constraining for analysis of knowledge-based services and are of lesser concern for analysis of transaction-based services.

Given the foregoing characteristics and limitations, TB&A's assessment is that fair market value could be determined for transaction-based services with some degree of confidence, but such estimates would be extremely unreliable, and of questionable usefulness, for knowledge-based services. In TB&A's view, a large portion of BellSouth's existing service-related affiliate transactions (to be determined as part of TB&A's analysis), are primarily knowledge-based and do not readily lend themselves to meaningful alternative provider analyses, and hence to estimates of fair market value.

2. <u>A major challenge for the use of estimated "fair market value" as proposed in the Notice is to ensure consistency in approach and interpretation, both within and among carriers.</u>

While theoretically the methodologies available to perform alternative provider analyses are limited, numerous methodologies have been applied. Many of these methodologies address value, but not necessarily "fair market value", both in their conceptual approach and their application. Based on the nature of the service and the purpose of the analysis, authors of these studies typically devise study approaches that select from numerous possible analysis criteria and gather data in varying levels of detail. In TB&A's view, a major challenge for the use of estimated fair market value, as proposed in the <u>Notice</u>, is to ensure consistency in approach and interpretation, both within and among carriers.

3. <u>The cost of conducting alternative provider analyses will be considerable.</u>

The estimated cost of conducting alternative provider analyses for BellSouth's existing service-related affiliate transactions, while indeterminate at this time, will be considerable. In addition to the requirement that the product or service be clearly identified, alternative provider studies can be conducted only if (1) the product or service is offered by external providers; (2) the product or service can be specified for quotation by external providers; and (3) alternative providers agree to provide estimates of the cost of providing the product or service. Each one of these steps is problematical. However, even if these steps could be accomplished, the resulting process would be costly and time consuming. Furthermore, estimates would need to be made of the associated internal costs of establishing and operating the interfaces for the alternative providers as well as any associated administrative and control costs.

In addition to the internal costs of providing all of the data for an estimate to an external provider, vendors may charge for the service of providing an estimate. While this may not pertain to the usual request for quotation (RFQ) process, in this case vendors can be expected to learn that their efforts probably will not be rewarded by the award of a contract. Since preparing an estimate requires significant effort on the part of vendors, it is likely that vendors will charge for this service, adding still another cost to conducting an alternative provider study.

It should also be noted that the cost of conducting an alternative provider study is a recurring expense, as such studies must be updated periodically to reflect changes in the products or services offered as well as changes in market conditions. Thus, TB&A concludes that conducting alternative provider studies will result in considerable cost to the carriers.

B. The Adoption of the Proposed Rules Will Impose Substantial Costs on the Commission and the Public.

In BellSouth's view, adoption of the proposed rules will impose substantial new costs on the Commission, and hence the public. The Notice provides no guidance on how carriers are to estimate fair market value of services. In the absence of clear standards, there is certain to be disagreement between the carriers and the Commission staff on methodologies, procedures and results. Such uncertainty inevitably imposes additional requirements for staff resources at the Commission. At a time when Commission staff resources are already strained, the adoption of rules that will further burden those resources should be avoided unless clearly necessary to fulfill the Commission's responsibilities to the public. As demonstrated above, this is not such a case. Both the carriers and the Commission will incur substantial cost increases, with little if any public benefit.

In the Notice, the Commission recognizes that its proposed changes to the affiliate transaction rules meet the Commission's test for "exogenous cost" treatment under price caps.[19] BellSouth agrees. The additional administrative costs associated with implementation of these proposed rules

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[19] Notice at ¶ 35.